

SM/08/332
Correction 2

December 2, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **People's Republic of China—Hong Kong Special Administrative Region—Staff Report for the 2008 Article IV Consultation Discussions**

The attached corrections to SM/08/332 (11/13/08) have been provided by the staff:

Factual Errors Not Affecting the Presentation of Staff's Analysis or Views

Page 19, para. 28, line 5: for “introduce a minimum wage for selected low-wage occupations.” read “introduce an across-the-board minimum wage.”

Questions may be referred to Mr. Chalk (ext. 38281), Mr. Porter (ext. 37316) and Mr. Vitek (ext. 37393) in APD.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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Department Heads

27. **Assessment.** From a macroeconomic perspective, staff expressed concern that any voluntary financing scheme would lead to excessive consumption volatility and undersaving, particularly by lower income group in the early part of their working lives.¹ This ultimately could put renewed pressure on the fiscal accounts. Given that only around one-third of the labor force are in the income tax net, even full tax deductibility of healthcare-related savings would be an insufficient incentive to prevent such under-provisioning for future health costs. Therefore, staff believed it is likely that some form of mandatory scheme will be needed. In addition, the government would also need to continue to finance health coverage for those at the lower end of the income distribution as well as individuals with extraordinary healthcare needs. The authorities emphasized that they see the reform of healthcare financing as geared towards providing a supplement to the existing publicly financed scheme and that any changes would aim to preserve the freedom of choice of the current system. However, they noted that the consultation was at an early stage and, as it evolves, the proposals would become more concrete.

How Will a Minimum Wage Affect Hong Kong SAR's Flexible Labor Market?

28. **Background.** Two years ago, amid growing concerns over a worsening income distribution, Hong Kong SAR introduced the Wage Protection Movement with a voluntary minimum wage for security guards and cleaners. It has become clear that the voluntary nature of the scheme made it rather ineffective. Therefore, the Legislative Council will soon consider a proposal to introduce [a minimum wage for selected low-wage occupations and an across-the-board minimum wage](#).

29. **Design of the minimum wage.** The mission underlined the importance of ensuring that any legislation to introduce a new minimum wage be designed in a way that maintains the ability of Hong Kong's labor markets to adjust to shocks.

- **Level of the minimum wage.** The higher the level of minimum wage, the larger the impact on macroeconomic and employment volatility as quantities are forced to adjust to changing conditions, rather than wages and prices. Staff simulations² suggest that raising the coverage of the minimum wage would noticeably amplify swings in employment and output.
- **Adjustment mechanism.** Staff noted that any discretionary adjustment scheme—such as that decided by a minimum wage council—would find it difficult to reduce the minimum wage in the face of an economic downturn, as may be necessary. Staff simulations indicate that maintaining a fixed nominal minimum wage or indexing it to

¹ See D. Botman and N. Porter, “The Macroeconomic Impact of Healthcare Financing Alternatives: Reform Options for Hong Kong SAR,” IMF Working Paper (forthcoming).

² See N. Porter and F. Vitek, “A Structural Analysis of the Effects of Introducing a Minimum Wage in Hong Kong SAR,” IMF Working Paper (forthcoming).

the consumer price index would put a greater burden of adjustment on employment flows. Automatically adjusting the minimum wage alongside changes in average wages or unit labor costs would generate relatively less volatility.

- *Coverage.* The mission fully supported the government's decision to extend the minimum wage to the whole economy, rather than confining it to specific professions. The latter approach would result in distortions to the low-income labor market and create incentives for evasion of the minimum wage requirement.
- *Supplemental schemes.* The mission argued for initially setting the minimum wage conservatively and assessing its macroeconomic and social implications. If needed, consideration could be given to supplementing a lower minimum wage with additional support for the working poor through the social assistance system. The relatively narrow coverage of the income tax system would probably argue against any form of tax-related support (such as an earned income tax credit).

The authorities noted that there had, as yet, been no decision on either the design or level of the minimum wage. The next few months would be spent intensively improving the quality of the data on the economic conditions of the working poor. The government will establish a Minimum Wage Commission—drawing members from unions, business, academia, and the government—which will consider this data and make recommendations on the level of the minimum wage and review mechanisms during the course of the 2008/09 legislative session.

B. Reacting to Economic Change in the Pearl River Delta

30. *Background.* At the center of the major structural changes over the past decade has been a growing integration with the Pearl River Delta region of Mainland China (PRD). Manufacturing capacity has been mostly shifted into the PRD and Hong Kong SAR has, instead, leveraged its comparative advantages to provide services such as logistics, merchandizing, and finance to PRD enterprises (around 40 percent of all FDI outflows to the Mainland went to the PRD during 2001–06). Guangdong province has also become a major source of imports for Hong Kong SAR.

31. *Recent trends.* There was a uniform sense from both private and public sector counterparts that changes in the PRD are moving quickly. Low value-added, labor-intensive producers are being crowded out by rising labor costs, stricter enforcement of labor rights, and more rigorous environmental standards. The broader global economic slowdown is now accelerating this adjustment process. The direct spillovers from these rapid changes in PRD